Introduction:

The corporate credit union, in its current form, offers the natural person credit union a value proposition that is measurable and unique. Through cooperative ownership and direct governance natural person credit unions benefit from the efficiencies and aggregation that corporate credit unions apply to the following services.

- Payment processing including: paper items, ACH, credit and debit cards, and wires
- Direct settlement
- Payment products research and product development
- Coin and currency ordering and analysis
- Investing of overnight funds
- Lending of overnight liquidity
- Investing of long-term funds
- Lending of long-term liquidity
- Investment and lending research and product development
- Low cost brokerage services
- Security safekeeping
- Reverse repurchase lending
- Asset and liability management consulting
- Interest rate risk reporting
- Investment accounting
- Asset and liability management education
- Regulatory consulting
- Advocacy

A business model that leverages aggregation to achieve efficiencies and streamline processes across a comprehensive spectrum of services, combined with cooperative principles and volunteer leadership, has driven corporate credit unions to evolve over the years while competing daily for credit unions' business.

Despite this history, corporate credit unions have been deeply affected by the current, unprecedented financial crisis that began roughly 18 months ago and has caused the failure of numerous venerable financial institutions. Though corporate credit unions have sustained losses, their presence has given credit unions protected access to the larger financial marketplace. While it is clear that a degree of revision to the current structure is necessary to mitigate the risk corporates have taken on, it is critical that decisions about the future of the network do not hold corporates to an impossible standard or an infeasible business model. Reasonable adjustments to a good but imperfect business model will enable natural person credit unions to continue taking advantage of the corporate credit union value proposition that the vast majority have come to rely upon over the years.

Key Elements:

Any plan that seeks to reorganize the corporate credit union network should focus primarily on those elements that have not withstood the current economic crises. Systemic risk and capital levels within the corporate credit union network have emerged as key factors when evaluating the potential for corporate credit unions to fail at providing vital settlement services. Any new plan should reduce systemic risk within the credit union network and address the alignment of three critical drivers of risk

mitigation – that is a proper alignment between regulatory architecture, capital requirements and the value proposition.
The following pages describe specific ideas for the achievement of this objective in the form of responses to questions posed by the NCUA. The application of these recommendations, whether adopted in whole or in part, would ultimately produce a network of regional corporate credit unions. In this structure, U.S. Central would be scaled back in terms of its asset levels and complexity – a process that will occur gradually as its portfolio winds down. We anticipate that corporates would form regional institutions that would duplicate the infrastructure of U.S. Central to provide credit unions access to liquidity and competitive investment vehicles. This Regional Corporate Network (RCN) would allow for a balance between the necessity of gaining efficiencies relative to the business model of most independent corporates today and the critical goal of reducing systemic risk.

Because we anticipate the challenges of additional regulatory restrictions on investment activity and new capital requirements, we believe it would be impossible for independent credit unions to provide value to credit unions without consolidation. To further efficiencies by taking advantage of a proven infrastructure that is already in place, the continued presence of U.S. Central in the role of aggregator is also a key component of the RCN – albeit in the role of a CUSO, or managing only a small balance sheet as the bulk of risk-taking activity is pushed to regional corporates.

The case for a RCN is further supported by an assessment of credit union needs and preferences. A regional structure is ideal for maintaining "high-touch" aspects of the corporate value proposition. Credit unions have come to rely on services that demand a local presence and the deep familiarity that corporate staff have with members' individual balance sheets and requirements. Consultative sales, risk reporting, investment advisory and idea incubation are all functions that require interpersonal contact that would be unattainable in a single, centralized corporate. Further, representative governance is far more meaningful in a regional structure, as the backbone of building trusting relationships that are critical in attracting and maintain the deposits that generate income.

Low touch aspects of the corporate value proposition can be provided through national aggregation – maximizing efficiency and the value ultimately returned to credit unions. Examples of such low-touch services include payments, custody and brokerage. In addition, Georgia Central envisions an opportunity to create a national debt facility to capitalize on the high-quality collateral of credit unions' well-underwritten loans. The RCN could facilitate and FHLB-like funding mechanism that parlays these loans into system-wide AAA rated debt facility.

A national debt facility is just one of the many ways that regional corporates could collaborate to provide additional value for credit unions. It is our position that a significant reduction, if not total elimination, of competition among corporates will reap the benefits of unfettered cooperative innovation. This decline in competition among corporates could be mandated by the NCUA, but we believe that an organic reduction in competition will occur with the institution of capitalization requirements. In particular, Georgia Central envisions that credit unions would be required to invest perpetual capital in each and every corporate where they do business.

Georgia Central's responses to the questions posed in the ANPR are presented in detail, along with supporting appendices, in this report. Each of Georgia Central's recommendations supports the development of a RCN, which we are confident would address the key concerns of liquidity, capital and systemic risk without necessitating actions that would substantially reduce the value proposition that corporates are uniquely positioned to provide.

Payment Systems

On behalf of the 171 Georgia credit unions, Georgia Central processes or settles the following each month:

ACH Services – Over 4,000 items are originated each month for a total dollar volume of $43 million and more than 9,000 returns are processed for a total of approximately $1.5 billion. In addition, Georgia Central processes nearly 4,500 manual settlement entries for credit unions totaling $38 million per month.

Wire Transfers – Georgia Central processes wire transfers for approximately 112 credit unions with total average volumes for incoming and outgoing wires combined at 5,000 per month. Georgia Central process over $2.4 billion per month in wire transfer dollars.

International Wire Transfers – Georgia Central processes international wire transfers on behalf of approximately 40 credit unions. Average volumes per month are 155 for total monthly dollar volumes of $698,990.

Check Collection – CSI provides check collection services to 109 credit unions with those items settling through Georgia Central. On average, we see a monthly volume of 1,620,000 for a total dollar volume of $450 million.

Coin and Currency – Georgia Central provides coin and currency facilitation for over 60 credit unions with monthly volumes around 640 orders and dollar volumes of $120 million.

Share Drafts – CSI provides share draft services to 119 credit unions with the majority of those items settling through Georgia Central. On average, we see monthly volumes of 3,500,000 for a total dollar volume of $934 million.

Official Checks – Through Avenue C, Georgia Central has monthly volumes around 3,670 items totaling $9.8 million in total dollar volume.

EFT Services – The Georgia Credit Union League offers EFT Services to over 70 credit unions and experiences monthly volumes around 5,697,949, which settle through Georgia Central.

Credit Card Services – The Georgia Credit Union League offers credit card services to over 50 credit unions. Monthly volumes are reported at 411,066 with $28 million in total dollar volume, all of which settles through Georgia Central.

On behalf of the 8,700+ credit unions, corporates process the following at the national level:

ACH Services – Of the average monthly volume of 25.7 million totaling an average of $60 billion, U.S. Central processes 25.3 million of the volume total and $11.25 billion of the dollar total.

Automated Settlement (largely vendor payments) and **Manual Corporate Settlement** – Of the average monthly volume of 7.3 million items and $91 billion in value, U.S. Central processes 770,000 of the transactions and $86.5 billion of the dollars.

Wire Transfers – Breaking down the average 175,000 monthly volume and $305 billion in dollar value, U.S. Central processes 13,700 of the wire transfers and $16 billion of the dollar total.

International Transfers – Breaking down the average 9,400 monthly volume and $107 million dollar value, U.S. Central processes 4,800 of the international transfers and $47.8 million of the dollar total.

Bill Pay Services – Of the average monthly volume of 2 million transactions and $416 million in dollar value, U.S. Central processes 1.4 million of the transactions and $400 million of the dollar value.

In addition to the volumes processed by U.S. Central on behalf of the Corporate Network as described above, corporates transact activities associated with Item Processing, Remote Deposit Processing, Coin and Currency, and Card Processing.

Item Processing – On behalf of the credit unions, the corporates process over 106 million items totaling $35 billion dollars.

Remote Deposit Processing – On behalf of the credit unions, the corporates process over 31.5 million transactions totaling $21 billion dollars.

Coin and Currency – On behalf credit unions nationwide, corporates process over 34,000 transactions totaling $3.5 billion in dollar volume.

Card Processing – On behalf of the credit unions, corporates and Leagues process and settle over 11 million transactions totaling $147 million in dollar volume.

In summary, of the approximate average monthly volume of 184 million items with a dollar value of $588 billion across all services in the data table, U.S. Central processes about 27.5 million (15%) of the volume and $178 billion (30%) of the dollar value. The expertise and unique systems that have evolved over the past thirty years to facilitate this activity are critical to credit unions' daily operations and therefore should be protected on two fronts – payments and settlement cannot be allowed to fail due to system risk; however, this sophisticated level of aggregation and efficiency cannot be dismantled as part of a restructuring of the Corporate Network.

Questions posed in the ANPR:

1. *Should payment system services be isolated from other services to separate the risks? If so, what is the best structure for isolating these services from other business risks?*
2. *Should there be a charter that strictly limits corporates to operating a payment system only?*
3. *Is there sufficient earnings potential in offering payment systems to support a limited business model that is restricted to payment systems services only?*

Separation of payments from the other services that corporates provide would create insurmountable inefficiencies. To maintain the primary financial institution (PFI) relationship with credit unions, corporates must be able to offer a full line of account support services, including settlement, payment and correspondent services, investing and lending options.

Historically, the cost of providing payments and settlement activities has been subsidized by earnings from balance sheet activities. There would not be sufficient earnings potential in a business model that separates payments activity from the investment side of the business without causing a dramatic increase in expense to credit unions. If the Corporate Network payment solution becomes uncompetitive, a limited number of larger credit unions would most likely be able to find alternative service providers (though in doing so, losing a great deal of efficiency relative to the streamlined payments/settlement function that is unique to the corporate model), while the smaller and medium-sized credit unions that make up the greater part of the movement might not be able to do so.

Rather than separating payments from other account-management services, it would be appropriate to consider alternative approaches to mitigate the risk brought to payments by the investing activity of corporates, such as:

- In recognition of the fact that concerns surrounding payment systems are actually *liquidity* concerns (as corporates have successfully managed the operational risks associated with payments very successfully for decades), it may be appropriate to set aside net settlement funds for a specified number of days to ensure funds are available to settle member transactions.
- A statistical analysis of historical intra-month settlement balances could be performed to determine the volatility of settlement cash flows. Corporate credit unions could extrapolate these results to quantify how much cash is appropriate to cover settlement over a pre-determined statistical range. Georgia Central currently uses such an analysis to determine settlement portfolio cash concentration limits.

Georgia Central supports a payments CUSO model wherein additional efficiencies might be achieved (or replaced, in the event that U.S. Central's status as a full-service financial institution is diminished); however, it is critical that corporates own and set the direction for such a CUSO while maintaining contracts for the services provided directly with credit unions. It is feasible that this approach could be facilitated by a future version of U.S. Central, where the ownership structure is already in place.

Liquidity and liquidity management proposals

Corporates' ability to offer its members liquidity services is a key component of their value as cash management providers and is integral to maintaining the entire member relationship.

Questions posed in the ANPR:

1. *What steps should be taken, and by whom, to preserve and strengthen corporates' ability to offer liquidity services?*

The NCUA might consider regulatory changes designed to mitigate liquidity (or cash flow) risk. For example:

- As stated in the payment systems section, corporates could be required to set aside a portion of liquidity specifically to fund credit union settlement, determined to accommodate the timing of settlement for debits and credits as well as the daily, monthly and annual cyclical activity levels.
- All corporate credit unions should be required to have multiple documented sources for liquidity.
- Establishing a system-wide liquidity warehouse wherein all corporates agree to allocate a pool of dollars would create an intra-network support mechanism.
- Corporates working as a network could obtain a shared debt rating similar to the FHLB System and issue debt along a spectrum of maturity buckets, such as commercial paper and short-term and medium-term notes.
- Improve the CLF, which has thus far been a valuable tool for the NCUA throughout the credit and liquidity crisis. Legislative barriers currently prohibit or hamper efforts to fully address the crisis. Some improvements might include: 1) the ability to provide secured amortizing notes payable; 2) the ability to enter into repurchase agreements and conduct repurchase transactions with corporate investment securities; 3) direct deposits, investments and/or capital infusions in corporates and credit unions.

2. *Should the NCUA consider limiting a corporate's ability to offer other specific types of products and services in order to preserve and defend the liquidity function? What specific types of products and services should corporates be authorized to provide?*

The member credit union "marketplace" should determine what products and services are offered. It is the responsibility of the corporate and its regulatory agency to determine a safe and sound means, including appropriate capital requirements, to offer the products and services its members need, recognizing that at times the implementation of risk-mitigation strategy may cause an offering to be unprofitable or too expensive for credit unions to deploy.

3. *Should the NCUA add aggregate cash flow duration limitations to Part 704? If so, describe how this requirement should be structured, and also identify how such limitations would benefit liquidity management. What cash flow duration limits would be appropriate for corporates particularly in an evolving interest rate market with previously unseen credit risk spreads?*

Policies should be designed to facilitate the segmentation of a corporate's deposits, establish liquidity needs for each segment, and match off investments accordingly. For example, at Georgia Central there is a 30% swing in the settlement portfolio throughout the month; an approach that has worked very well throughout the years is a policy-driven requirement for holding 25% of this portfolio in cash at the beginning of the month. The NCUA should develop a methodology that can be applied broadly to ensure that deposits and investments are well-matched at corporate credit unions, taking into account cyclical fluctuations.

Relying solely on duration targets introduces a concern that next-day cash flow requirements might be ignored even while aggregate duration limits are observed.

Field of Membership Issues

Granting national fields of membership did foster competition as well as increased risk-taking, as cited in the ANPR. It also contributed to:

- Margin compression, lower return on assets and slower capital accumulation;
- Better rates for member credit unions;
- Fragmented innovation and product operations as corporates sought ways to gain advantages over other corporates;
- Reduction in cooperation, trust and utilization of shared resources such as U.S. Central.

It is important that a future structure eliminates or greatly reduces competition between corporates. Competition is nearly always a productive force; however, the value of mass cooperation among corporates will produce much greater value to credit unions than mass competition has been able to achieve. The level of competition from numerous non-corporate providers is sufficient to ensure ongoing innovation, service and competitive pricing.

Question from the ANPR:

1. *Should the agency return to defined FOMs to address what they perceive as risk associated to expanding FOM?*

It is not necessary to enforce a defined FOM to mitigate risk; rather, this can be accomplished by requiring credit unions to provide GAAP-qualifying capital at each corporate where they use services. In this scenario, credit unions would have a choice of which corporate(s) to capitalize, yet would be unlikely to desire to capitalize more than one due to the perpetual nature of this capital, thereby reducing if not eliminating competition.

Expanded Investment Authority

Currently, Part 704 provides an option by which corporates meeting certain criteria can qualify for expanded investment authority. At each level of expanded authority, corporates are only allowed to purchase highly-rated securities and have well-defined guidance for risk exposure. Regulation and guidance have evolved with the financial markets and have proven adequate prior to the current extreme credit crisis.

Questions from the ANPR:

1. *Does the need for expanded authorities continue to exist? If so, should NCUA modify the procedures and qualifications by which corporates currently qualify for expanded authorities? If so, what should the new standards be?*
2. *Should NCUA reduce the expanded authorities available? If so, which ones?*
3. *Alternatively, should any of the limits in existing expanded authorities be reduced or increased? If so, which ones?*
4. *Once granted, should NCUA require periodic requalification for expanded authorities? If so, what should be the timeframe?*

Expanded authority enables corporate credit unions to leverage expertise to provide credit unions access to the larger marketplace. Corporates use expanded authorities to increase investment options (to achieve both diversification and yield), create product offerings, mitigate risks (using derivatives), and facilitate member liquidity by participating in member loans. These tools have valid applications and are available to institutions outside the Corporate Network that are competitors. Today, the NCUA grants specific authorities and sets limits based on a corporate's capital, risk profile and expertise. Access to expanded authorities requires significant investment in staff, systems and process development.

The need for expanded authorities continues to exist and should not be curtailed. Each type of investment activity engaged in under the expanded authority umbrella presents risk, which can be mitigated through appropriate capitalization and other strategies.

The NCUA should continue to use the examination process as its means for assessing whether a corporate is fulfilling all the requirements necessary to hold previously granted expanded authorities.

Further, because natural person credit unions hold the vast majority of the system capital, the NCUA should consider providing expanded authority capabilities at this level as warranted by experience and expertise.

For a detailed list of the specific authorities available to corporates, see Appendix I.

Structure: two-tiered system
The corporate system is made up of two-tiers: a retail network of corporates that provide products and services to NPCUs, and a single, wholesale corporate (U.S. Central) that exclusively services the retail corporates.

Questions from the ANPR:

1. *Does the two-tier corporate system in its current form meet the needs of credit unions?*
2. *Is there a continuing need for a wholesale corporate credit union? If so, what should be its primary role?*
3. *Should there be a differentiation in powers and authorities between retail and wholesale corporates?*

The two tier structure does effectively meet the needs of natural person credit unions. It could be argued that it is not efficient to capitalize the wholesale structure at two levels and that it would be better to collapse the structure into a single tier.

The most efficient solution would be a single wholesale corporate, such as U.S. Central, in which credit unions would invest directly; however, this is not the best option because it concentrates all of the risk in a single organization – exacerbating the system risk already present in the Network. On the other hand, a multiple-corporate option would spread out this risk but would be less efficient. These inefficiencies could be tempered if *competition were replaced with increased cooperation* (which could lead to consolidation with common back-office functions). Solutions for enabling credit union diversification of investments and borrowing must be implemented to ensure that the Corporate Network retains credit unions' business, increasing earnings and capital accumulation.

In one form or another, the systems that have been established at the wholesale corporate level continue to be relevant because of the aggregation and efficiency they provide. Transitioning U.S. Central's role to more off balance sheet asset management and other back office functions such as settlement, Asset/Liability Management, risk assessment, and external funding could provide for greater stability and more efficient utilization of capital. Identifying the most effective way to perform these central functions for the Network is critical for continued innovation and effective risk management.

Transitioning U.S. Central's role away from on balance sheet term investments will require all corporates to have the capability to effectively manage investments, liquidity, risk and other functions and have their capital aligned with these activities. The more that corporates cooperate to create efficiencies, the better the industry will be served and the value proposition of corporates will increase. Ultimately, the marketplace, the level of cooperation, and the expenses to operate in a safe and sound manner will determine the number of corporate credit unions.

Questions from the ANPR:

3. *Does the current configuration result in the inappropriate transfer of risk from the retail corporates to the wholesale corporate?*
4. *Should capital requirements and risk measurement criteria (e.g., NEV volatility), be different from those requirements that apply to a retail corporate credit union?*

Certainly, a transfer of risk occurs, but it may or may not be inappropriate. It is a business model that has functioned effectively for many years and returned a great deal of value to natural person credit unions that may not have the personnel, expertise or investment authority to take on risk individually. This business model could continue to bring value as long as it is properly capitalized. More capital should be required if the business model remains unchanged; there should be greater flexibility in risk measurement criteria, such that if the business model of U.S. Central were changed to that of a payments/settlement CUSO, less capital would be needed.

Corporate Capital

NCUA is considering revising various definitions and standards for determining appropriate capital requirements for corporates. These changes would bring the corporate capital requirements more into line with standards applied by other federal financial regulators.

Core Capital

Questions from the ANPR:

1. *Should the NCUA establish a new capital ratio that corporates must meet consisting only of core capital, and if so, what would be the appropriate level to require?*
2. *What actions are necessary to enable corporates to attain a sufficient core capital ratio?*
3. *What would be an appropriate time frame for corporates to attain sufficient capital?*

Under the current rule, core capital is defined as retained earnings plus paid-in capital.

The NCUA should consider altering its capital requirements to mirror those of the Basel I Accord, consisting of a minimum 4% Tier 1 capital ratio requirement. This Tier 1 requirement would parallel the existing core capital ratio requirement (which counts retained earnings and paid-in capital), and is set at 3%; a key difference would be that only *perpetual* paid-in capital would qualify. However, due to the volatility in asset levels that stems from the business model. Membership Capital Shares (MCS) may still serve a purpose as a patronage-based form of capital. Rather than requiring PCA type remedies if the 4% Tier 1 ratio is breached, the current methodology of reserving and capital restoration planning should be maintained based on a total capital requirement that includes MCS.

Credit unions would have to purchase perpetual PIC from the corporates where they do business. Some corporates such as Georgia Central have offered its members fixed-term PIC in the past. Hypothetically, if this requirement went into effect today, in the case of Georgia Central, perpetual PIC would be made up of a conversion of all existing fixed-term PIC ($13 million) and at least half of credit unions' MCS ($25 million of the $50 million balance) to the new, perpetual capital.

In addition, corporates would have to shrink the size of their balance sheets by moving more credit union deposits into brokered investment types such as SimpliCD, Agencies and other yet-to-be developed off-balance sheet options.

An appropriate time frame for this to occur would be 24 months.

Questions from the ANPR:

4. *What is the appropriate method to measure core capital given the significant fluctuation in corporate assets that occur?*

The ratio using Daily Average Net Assets (DANA), which averages daily assets for a twelve month period, and is employed today, would provide an appropriate long-term view. However it may also be necessary to watch a monthly ratio to stay abreast of rapidly changing asset levels that might occur during a liquidity crisis.

5. *What is the correct degree of emphasis that should be placed on generating core capital through undivided earnings?*

The manner in which a corporate improves its capital ratios should be left to the discretion of the individual corporate credit union. Mandating the accelerated accumulation of retained earnings would have a severely negative impact on credit union users of corporate services. The ability of corporates to raise perpetual PIC can and should be a direct reflection of members' perceived value of their corporate, and ultimately will determine the long-term viability of individual corporates.

6. *Should there be a requirement that a corporate limit its services only to members maintaining contributed core capital with the corporate*?

Yes. This requirement will not only improve corporate capital ratios quickly, but also will go far to reduce the risks associated with extreme competition among corporates in recent years.

7. *Offer any other suggestions or comments related to core capital for corporates.*

A two-tiered approach to capitalizing corporate credit unions should be employed. First, an asset-based perpetual PIC investment will create a stable foundation – meaning that the combination of retained earnings and perpetual PIC would be sufficient to meet a 4% Tier 1 ratio requirement; second, a patronage-based capital account will allow the level of capital to ebb and flow in tandem with the risk the corporate is taking on behalf of each individual member credit union at any given point in time.

Membership Capital

Questions from the ANPR:

1. *Should the NCUA continue to allow membership capital in its current configuration, or should the agency eliminate or modify certain features, such as the adjustment feature, so that membership capital meets the traditionally accepted definition of tier two capital?*
2. *Should adjusted balance requirements be tied only to assets?*
3. *Should the NCUA impose limits on the frequency of adjustments?*
4. *Should the agency require that any attempted reduction in membership capital based on downward adjustment automatically result in the account being placed on notice, within the meaning §704.3(b)(3), so that only a delayed payout after the three-year notice expires is permissible?*
5. *Should there be a requirement that any withdrawal of membership capital be conditioned on the corporate's ability to meet all applicable capital requirements following withdrawal?*

Capital should take on two distinct forms as described above, allowing traditional MCS to retain an adjustment feature; it may be appropriate for regulation to mandate a patronage basis for this adjustment – on a semi-annual or quarterly basis. In this scenario, perpetual PIC would be tied exclusively to assets while allowing for flexibility with MCS. Because MCS would be patronage based and adjusted often, there would be no notice provision; instead, it would be mandatory to hold a requisite amount of MCS based on patronage at all times. An overarching requirement would be that all withdrawals of any type of capital be conditioned on the corporate's ability to meet all applicable capital requirements.

Risk-based capital and contributed capital requirements

Questions from the ANPR:

1. *Should NCUA consider risk-based capital for corporates consistent with that currently required of other federally regulated financial institutions?*
2. *What regulatory and statutory changes, if any, would be required to effectuate such a change?*

Yes. A new 4% Tier 1 capital ratio should parallel what has been set out by the FRB to complement Basel relative to risk-based assets. To compensate for differences in institutional assets, corporates with riskier assets would be required to hold more capital. The Basel Committee on Banking Supervision has embraced precisely such a risk-weighted approach. *More risk, more capital.*

Capital requirements can at least partially be based on the relative riskiness of various types of assets. "Basel I," the first Basel Accord of 1988, introduced "risk buckets" for this purpose. For instance, loans received a risk weight of 100%, government bonds a risk weight of 0%. "Basel II" – the revision of the first Basel Accord – which is currently being implemented, goes beyond these rather crude risk buckets by differentiating risk in more detail, inclusive of criteria that attempts to incorporate various types of credit quality.

The risked-weighted capital requirement would be in addition to, not instead of, a 4% Tier 1 capital (a.k.a. leverage) ratio. Basel I requires financial institutions to hold 8% of Tier 1 capital when assets are weighted according to credit risk. This requirement when applied to corporate credit unions would give depositors transparency to the levels of credit risk embedded on the corporate credit union balance sheet.

Questions from the ANPR:

3. *Should a natural person credit union be required to maintain a contributed capital account with its corporate as a prerequisite to obtaining services from the corporate?*
4. *Should contributed capital be calculated as a function of share balances maintained with the corporate? What about using asset size?*

A segment of membership capital should be calculated as a function of share balances, while asset size is a more appropriate basis for "contributed capital" – which should be a requirement for membership and the use of any corporate services. Contributed capital (referenced above as perpetual PIC) should be required to be collected in such an amount as to move the corporate's core capital ratio (or a new, Tier 1 capital ratio) to at least 4% (when combined with retained earnings).

Permissible Investments

NCUA is considering whether the corporate investment authorities should be constrained or restricted. Presently, corporates have the authority to purchase and hold investments that would not be permissible for natural person FCU members under Part 703 (or, in some cases, outside of what is authorized for a state chartered credit union).

Questions from the ANPR:

1. *Should the NCUA limit corporates' investment authorities to those allowed for NPCUs?*
2. *Should the NCUA prohibit certain categories of, or specific, investments?*

Limiting corporates' investment authorities to those allowed for natural person credit unions would be an overreaction to current events that could dramatically reduce the value proposition of the corporate business model. Credit union need for a wide range of permissible investments, level of investment expertise, and extent of investment and risk infrastructure differs substantially from that of corporates. Credit union infrastructure and expertise is understandably more extensive and appropriately allocated to member lending activities. Corporate balance sheets, which represent primarily investment of credit unions' liquid assets, require a wider range of short-term investment alternatives along with more extensive investment and risk management infrastructure and expertise.

Some currently authorized investment types should not be permissible or, if permissible, be subject to conditions, such as NIMs and most CDO structures. Other investment types where the volatility of credit risk is leveraged through structure (e.g. when a 10% change in volatility results in a 100% change in the underlying risk posture) should be prohibited. Examples of investment types that should be prohibited or conditioned include long-term interest-only strips, long-term principal-only strips, and some types of leveraged floaters and inverse floaters.

Further, it would be appropriate to develop a mechanism for making ongoing determinations of what should be prohibited, as the market and investment vehicles evolve. Certain characteristics should be identified as being inappropriate for corporate investing.

Concentration in a limited number of investment types has played a large role in the current crisis and should be mitigated through concentration limits.

To review the current regulations surrounding permissible and prohibited investment activities for credit unions and for corporates, see Appendix II.

Credit Risk Management

Questions from the ANPR:

1. *Should the NCUA limit the extent to which a corporate may rely on credit ratings provided by Nationally Recognized Statistical Rating Organizations (NRSROs)?*
2. *Should the NCUA require more than one rating for an investment, or require that the lowest rating meet the minimum rating requirements of Part 704?*

Yes; this is currently provided for in the existing regulation but additional supervision and enforcement may be needed. The regulation stipulates that a corporate must choose a single NRSRO and use its ratings exclusively. A multiple rating requirement is a sound business practice that should be added to regulation, but requiring that the corporate always select the lowest rating is far too conservative. A combination of ratings and other internal credit review activities will provide the best assessment of a securities' credit risk. It is important to note that in the current financial crisis, the vast majority of investments purchased by U.S. Central and corporates received the highest ratings from multiple NRSROs.

Questions from the ANPR:

3. *Should the NCUA require additional stress modeling tools in the regulation to enhance credit risk management?*
4. *Should Part 704 be revised to lessen the reliance on NRSRO ratings?*
5. *Identify any other changes that may be prudent to help assure adequate management of credit risk. Considerations should include whether Part 704 should be revised to provide specific concentration limits, including sector and obligor limits.*
6. *What specific limits would be appropriate for corporates?*
7. *Should corporates be required to obtain independent evaluations of credit risk in their investment portfolios?*
8. *Should corporates be required to test sensitivities to credit spread widening, and if so, what standards should apply to that effort?*

Additional stress modeling tools and limits would be appropriate. For example, stress tests on the structure of the deals and the use of stress modeling tools for pre-purchase analysis would provide value. Periodic third party valuation of collateral performance is also warranted. The NCUA should maintain a list of approved contractors for this type of work. Further, concentration limitations by sector (e.g. credit card ABS, auto ABS and residential mortgage-backed securities) and obligor (set at five times capital per sector) would be appropriate, but should be scalable based on capital relative to risk. A two-year review of historical spread widening with historical wide levels used as a proxy for credit risk would provide value. This test applied to minimum NEV ratio requirements would provide a credit risk limit.

To view the full regulation surrounding corporate credit union risk management, see Appendix III:

Asset Liability Management

Under past rules, the NCUA required corporates to perform net interest income modeling and stress testing. The agency is considering re-instating that requirement in light of the current market. Alternatively, the agency may consider some form of mandatory modeling and testing of credit spread increases.

Question from the ANPR:

1. *Should the NCUA require corporates to use monitoring tools to identify these types of trends, including specifically comments about tangible benefits, if any, which would flow from these types of modeling requirements?*

Stress testing and income simulations are occurring at corporates today; additional monitoring as part of the examination process may be needed. Interest income modeling does not seem to be a likely outcome of any forthcoming rewrite of 704, as income adequacy has not played a role in the current crisis; however, best practices demand that internal reporting at corporates include some form of tracking for investment income at a detailed level on a daily basis.

To view the relevant regulation surrounding corporate Asset-Liability Management, see Appendix IV.

Corporate Governance

Question from the ANPR:

1. *Should the NCUA require that a director possess an appropriate level of experience and independence?*
2. *Should the agency set term limits, allow compensation for corporate directors, and require greater transparency for executive compensation?*
3. *Is the current structure of retail and wholesale corporate credit union boards appropriate given the corporate business model?*

Some guidelines may be appropriate; however, experience/expertise should be scalable based on the type of authorities each individual corporate has. It would be difficult to obtain independence for corporate directors without going outside the industry. Arbitrary term limits should not determine the length of service of experienced, committed directors; compensation of directors infringes on the cooperative principles of volunteer governance and muddies the water on the issue of motivation. The board of directors, as the elected representatives of their peer credit unions, may be depended on to give due consideration in the establishment of executive compensation; state-chartered corporates currently report executive compensation to the IRS.

The present structure of the retail and wholesale corporate credit unions' boards is appropriate because it ensures that the individuals making decisions have a vested interest in common with the parties they represent (and is parallel with that used by natural person credit unions – member representation). Reaching deeper (such as by adding credit union representation at U.S. Central or natural person members at a retail corporate) would only dilute the value that more direct representatives can provide. However, a degree of participation from the broader populace (such as through product councils and the like) is an appropriate direction for any board to consider.

Question from the ANPR:

4. *Should NCUA establish more stringent minimum qualifications and training requirements for individuals serving as corporate credit union directors? If so, what should the minimum qualifications be?*
5. *Should the NCUA establish a category of "outside director," (persons who are not officers of that corporate), officers of member natural person credit unions, and/or individuals from entirely outside the credit union industry? Should the NCUA require that corporates select some minimum number of outside directors for their boards?*
6. *Should US Central be required to have some directors from NPCUs?*
7. *Comment is also sought on whether corporate directors should be compensated, and, if so, whether such compensation should be limited to outside directors only.*

Minimum qualifications beyond what exists today for directors would be difficult to set without becoming overly restrictive as it would be nearly impossible to consider the range of experience that might realistically qualify an individual to serve as a director. Other methods such as ongoing training and peer reviews might be useful. Representation on a board by industry experts outside the credit union arena may be appropriate, contingent upon the level of expanded authorities individual corporates maintain. In the event that it is determined that a corporate would benefit, based on the scope of its risk-taking activities, from having an "outside director" on the board, compensation may be appropriate and necessary for such an individual.

Appendix I: Expanded Investment Authorities Available to Corporates Today:

Base-Plus (Georgia Central is a base-plus corporate)

A corporate that has met the requirements for this Base-plus authority may, in performing the rate stress tests set forth in § 704.8(d)(1)(i), allow its NEV to decline as much as 20 percent.

Part I

(a) A corporate credit union that has met the requirements for this Part I may:

(1) Purchase investments with long-term ratings no lower than A– (or equivalent);

(2) Purchase investments with short-term ratings no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than A– (or equivalent) or the investment is a domestically-issued asset-backed security;

(3) Engage in short sales of permissible investments to reduce interest rate risk;

(4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and

(5) Enter into a dollar roll transaction.

(b) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 300 percent of capital.

(c) In performing the rate stress tests set forth in § 704.8(d)(1)(i), the NEV of a corporate credit union that has met the requirements of this Part I may decline as much as:

(1) 20 percent;

(2) 28 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; or

(3) 35 percent if the corporate credit union has a 6 percent minimum capital ratio and is specifically approved by NCUA.

(d) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 100 percent of the corporate credit union's capital. The board of directors must establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

Part II

(a) A corporate credit union that has met the requirements for this Part II may:

(1) Purchase investments with long-term ratings no lower than BBB (flat) (or equivalent). The aggregate of all investments rated BBB+ (or equivalent) or lower in any single obligor is not to exceed 25 percent of capital;

(2) Purchase investments with short-term ratings no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than BBB (flat) (or equivalent) or the investment is a domestically issued asset backed security;

(3) Engage in short sales of permissible investments to reduce interest rate risk;

(4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and

(5) Enter into a dollar roll transaction.

(b) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 400 percent of capital.

(c) In performing the rate stress tests set forth in § 704.8(d)(1)(i), the NEV of a corporate credit union which has met the requirements of this Part II may decline as much as:

(1) 20 percent;

(2) 28 percent if the corporate credit union has a 5 percent minimum capital ratio and is specifically approved by NCUA; or

(3) 35 percent if the corporate credit union has a 6 percent minimum capital ratio and is specifically approved by NCUA.

(d) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 100 percent of the corporate credit union's capital. The board of directors must establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

Part III

(a) A corporate credit union that has met the requirements of either Part I or Part II of this Appendix and the additional requirements for Part III may invest in:

(1) Debt obligations of a foreign country;

(2) Deposits and debt obligations of foreign banks or obligations guaranteed by these banks;

(3) Marketable debt obligations of foreign corporations. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and

(4) Foreign issued asset-backed securities.

(b) All foreign investments are subject to the following requirements: (1) Investments must be rated no lower than the minimum permissible domestic rating under the corporate credit union's Part I or Part II authority;

(2) A sovereign issuer, and/or the country in which an obligor is organized, must have a long-term foreign currency (non-local currency) debt rating no lower than AA– (or equivalent);

(3) For each approved foreign bank line, the corporate credit union must identify the specific banking centers and branches to which it will lend funds;

(4) Obligations of any single foreign obligor may not exceed 50 percent of capital; and

(5) Obligations in any single foreign country may not exceed 250 percent of capital.

Part IV

(a) A corporate credit union that has met the requirements for this Part IV may enter into derivative transactions specifically approved by NCUA to:

(1) Create structured products;

(2) Manage its own balance sheet; and

(3) Hedge the balance sheets of its members.

(b) Credit Ratings:

(1) All derivative transactions are subject to the following requirements:

(i) If the counterparty is domestic, the counterparty rating must be no lower than the minimum permissible rating for comparable term permissible investments; and

(ii) If the counterparty is foreign, the corporate must have Part III expanded authority and the counterparty rating must be no lower than the minimum permissible rating for a comparable term investment under Part III Authority (iii) Any rating(s) relied upon to meet the requirements of this part must be identified at the time the transaction is entered into and must be monitored for as long as the contract remains open.

(iv) Section 704.10 of this part if:

(A) one rating was relied upon to meet the requirements of this part and that rating is downgraded below the minimum rating requirements of this part; or

(B) two or more ratings were relied upon to meet the requirements of this part and at least two of those ratings are downgraded below the minimum rating requirements of this part.

(2) Exceptions. Credit ratings are not required for derivative transactions with:

(i) Domestically chartered credit unions;

(ii) U.S. government sponsored enterprises; or

(iii) Counterparties if the transaction is fully guaranteed by an entity with a minimum permissible rating for comparable term investments.

Part V

A corporate credit union that has met the requirements for this Part V may participate in loans with member natural person credit unions as approved by the OCCU Director and subject to the following:

(a) The maximum aggregate amount of participation loans with any one member credit union must not exceed 25 percent of capital; and

(b) The maximum aggregate amount of participation loans with all member credit unions will be determined on a case-by-case basis by the OCCU Director.

Appendix II: Current regulations Surrounding Permissible Investment Activities:

Credit Unions:

§ 703.13 Permissible investment activities.
(a) *Regular way settlement and delivery versus payment basis.* A Federal credit union may only contract for the purchase or sale of a security as long as the delivery of the security is by regular way settlement and the transaction is accomplished on a delivery versus payment basis.
(b) *Federal funds*. A Federal credit union may sell Federal funds to an institution described in Section 107(8) of the Act and credit unions, as long as the interest or other consideration received from the financial institution is at the market rate for Federal funds transactions.
(c) *Investment repurchase transaction.* A Federal credit union may enter into an investment repurchase transaction so long as:
(1) Any securities the Federal credit union receives are permissible investments for Federal credit unions, the Federal credit union, or its agent, either takes physical possession or control of the repurchase securities or is recorded as owner of them through the Federal Reserve Book Entry Securities Transfer System, the Federal credit union, or its agent, receives a daily assessment of their market value, including accrued interest, and the Federal credit union maintains adequate margins that reflect a risk assessment of the securities and the term of the transaction; and
(2) The Federal credit union has entered into signed contracts with all approved counterparties.
(d) *Borrowing repurchase transaction.* A Federal credit union may enter into a borrowing repurchase transaction so long as:
(1) The transaction meets the requirements of paragraph (c) of this section;
(2) Any cash the Federal credit union receives is subject to the borrowing limit specified in Section 107(9) of the Act, and any investments the Federal credit union purchases with that cash are permissible for Federal credit unions; and
(3) The investments referenced in paragraph (d)(2) of this section mature no later than the maturity of the borrowing repurchase transaction.
(e) *Securities lending transaction*. A Federal credit union may enter into a securities lending transaction so long as:
(1) The Federal credit union receives written confirmation of the loan;
(2) Any collateral the Federal credit union receives is a legal investment for Federal credit unions, the Federal credit union, or its agent, obtains a first priority security interest in the collateral by taking physical possession or control of the collateral, or is recorded as owner of the collateral through the Federal Reserve Book Entry Securities Transfer System; and the Federal credit union, or its agent, receives a daily assessment of the market value of the collateral, including accrued interest, and maintains adequate margin that reflects a risk assessment of the collateral and the term of the loan;
(3) Any cash the Federal credit union receives is subject to the borrowing limit specified in Section 107(9) of the Act, and any investments the Federal credit union purchases with that cash are permissible for Federal credit unions and mature no later than the maturity of the transaction; and
(4) The Federal credit union has executed a written loan and security agreement with the borrower.
(f)(1) *Trading securities*. A Federal credit union may trade securities, including engaging in when-issued trading and pair-off transactions, so long as the Federal credit union can show that it has sufficient resources, knowledge, systems, and procedures to handle the risks.
(2) A Federal credit union must record any security it purchases or sells for trading purposes at fair value on the trade date. The trade date is the date the Federal credit union commits, orally or in writing, to purchase or sell a security.

(3) At least monthly, the Federal credit union must give its board of directors or investment-related committee a written report listing all purchase and sale transactions of trading securities and the resulting gain or loss on an individual basis.

§ 703.14 Permissible investments.
(a) *Variable rate investment*. A Federal credit union may invest in a variable rate investment, as long as the index is tied to domestic interest rates and not, for example, to foreign currencies, foreign interest rates, or domestic or foreign commodity prices, equity prices, or inflation rates. For purposes of this part, the U.S. dollar-denominated London Interbank Offered Rate (LIBOR) is a domestic interest rate.
(b) *Corporate credit union shares or deposits*. A Federal credit union may purchase shares or deposits in a corporate credit union, except where the NCUA Board has notified it that the corporate credit union is not operating in compliance with part 704 of this chapter. A Federal credit union's aggregate amount of paid-in capital and membership capital, as defined in part 704 of this chapter, in one corporate credit union is limited to two percent of its assets measured at the time of investment or adjustment. A Federal credit union's aggregate amount of paid-in capital and membership capital in all corporate credit unions is limited to four percent of its assets measured at the time of investment or adjustment.
(c) *Registered investment company.* A Federal credit union may invest in a registered investment company or collective investment fund, as long as the prospectus of the company or fund restricts the investment portfolio to investments and investment transactions that are permissible for Federal credit unions.
(d) *Collateralized mortgage obligation/real estate mortgage investment conduit.* A Federal credit union may invest in a fixed or variable rate collateralized mortgage obligation/real estate mortgage investment conduit.
(e) *Municipal security*. A Federal credit union may purchase and hold a municipal security, as defined in Section 107(7)(K) of the Act, only if a nationally recognized statistical rating organization has rated it in one of the four highest rating categories.
(f) *Instruments issued by institutions described in Section 107(8) of the Act.* A Federal credit union may invest in the following instruments issued by an institution described in Section 107(8) of the Act:
(1) Yankee dollar deposits;
(2) Eurodollar deposits;
(3) Banker's acceptances;
(4) Deposit notes; and
(5) Bank notes with original weighted average maturities
of less than 5 years.
(g) *European financial options contract.* A Federal credit union may purchase a European financial options contract or a series of European financial options contracts only to fund the payment of dividends on member share certificates where the dividend rate is tied to an equity index provided:
(1) The option and dividend rate are based on a domestic equity index;
(2) Proceeds from the options are used only to fund dividends on the equity-linked share certificates;
(3) Dividends on the share certificates are derived solely from the change in the domestic equity index over a specified period;
(4) The options' expiration dates are no later than the maturity date of the share certificate.
(5) The certificate may be redeemed prior to the maturity date only upon the member's death or termination of the corresponding option;
(6) The total costs associated with the purchase of the option is known by the Federal credit union prior to effecting the transaction;
(7) The options are purchased at the same time the certificate is issued to the member.

(8) The counterparty to the transaction is a domestic counterparty and has been approved by the Federal credit union's board of directors;
(9) The counterparty to the transaction:
(i) Has a long-term, senior, unsecured debt rating from a nationally-recognized statistical rating organization of AA- (or equivalent) or better at the time of the transaction, and the contract between the counterparty and the Federal credit union specifies that if the long-term, senior, unsecured debt rating declines below AA-(or equivalent) then the counterparty agrees to post collateral with an independent party in an amount fully securing the value of the option; or
(ii) Posts collateral with an independent party in an amount fully securing the value of the option if the counterparty does not have a long-term, senior unsecured debt rating from a nationally-recognized statistical rating organization.
(10) Any collateral posted by the counterparty is a permissible investment for Federal credit unions and is valued daily by an independent third party along with the value of the option;
(11) The aggregate amount of equity-linked member share certificates does not exceed the credit union's net worth;
(12) The terms of the share certificate include a guarantee that there can be no loss of principal to the member regardless of changes in the value of the option unless the certificate is redeemed prior to maturity; and
(13) The Federal credit union provides its board of directors with a monthly report detailing at a minimum:
(i) The dollar amount of outstanding equity-linked share certificates;
(ii) Their maturities; and
(iii) The fair value of the options as determined by an independent third party.
(h) *Mortgage note repurchase transactions*. A federal credit union may invest in securities that are offered and sold pursuant to section 4(5) of the Securities Act of
1933, 15 U.S.C. 77d(5), only as a part of an investment repurchase agreement under §703.13(c), subject to the following conditions:
(1) The aggregate of the investments with any one counterparty is limited to 25 percent of the credit union's net worth and 100 percent of its net worth with all counterparties;
(2) At the time a federal credit union purchases the securities, the counterparty, or a party fully guaranteeing the transaction, must have outstanding debt with a long-term rating no lower than A- or its equivalent and outstanding debt with a short-term rating, if any, no lower than A-1 or its equivalent;
(3) The federal credit union must obtain a daily assessment of the market value of the securities under §703.13(c)(1) using an independent qualified agent;
(4) The mortgage note repurchase transaction is limited to a maximum term of 90 days;
(5) All mortgage note repurchase transactions will be conducted under tri-party custodial agreements; and
(6) A federal credit union must obtain an undivided interest in the securities.

Corporate Credit Unions

§ 704.5 Investments.
(a) *Policies*. A corporate credit union must operate according to an investment policy that is consistent with its other risk management policies, including, but not limited to, those related to credit risk management, asset and liability management, and liquidity management. The policy must address, at a minimum:
(1) Appropriate tests and criteria for evaluating investments and investment transactions before purchase; and

(2) Reasonable and supportable concentration limits for limited liquidity investments in relation to capital.
(b) *General*. All investments must be U.S. dollar denominated and subject to the credit policy restrictions set forth in § 704.6.
(c) *Authorized activities*. A corporate credit union may invest in:
(1) Securities, deposits, and obligations set forth in Sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act, 12 U.S.C. 1757(7), 1757(8), and 1757(15), except as provided in this section;
(2) Deposits in, the sale of federal funds to, and debt obligations of corporate credit unions, Section 107(8) institutions, and state banks, trust companies, and mutual savings banks not domiciled in the state in which the corporate credit union does business;
(3) Corporate CUSOs, as defined in and subject to the limitations of § 704.11;
(4) Marketable debt obligations of corporations chartered in the United States. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and
(5) Domestically-issued asset-backed securities.
(d) *Repurchase agreements*. A corporate credit union may enter into a repurchase agreement provided that:
(1) The corporate credit union, directly or through its agent, receives written confirmation of the transaction, and either takes physical possession or control of the repurchase securities or is recorded as owner of the repurchase securities through the Federal Reserve Book- Entry Securities Transfer System;
(2) The repurchase securities are legal investments for that corporate credit union;
(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of the repurchase securities and maintains adequate margin that reflects a risk assessment of the repurchase securities and the term of the transaction; and
(4) The corporate credit union has entered into signed contracts with all approved counterparties and agents, and ensures compliance with the contracts. Such contracts must address any supplemental terms and conditions necessary to meet the specific requirements of this part. Third party arrangements must be supported by tri-party contracts in which the repurchase securities are priced and reported daily and the tri-party agent ensures compliance; and
(e) *Securities Lending*. A corporate credit union may enter into a securities lending transaction provided that:
(1) The corporate credit union, directly or through its agent, receives written confirmation of the loan, obtains a first priority security interest in the collateral by taking physical possession or control of the collateral, or is recorded as owner of the collateral through the Federal
Reserve Book-Entry Securities Transfer System;
(2) The collateral is a legal investment for that corporate credit union;
(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of collateral and maintains adequate margin that reflects a risk assessment of the collateral and terms of the loan; and
(4) The corporate credit union has entered into signed contracts with all agents and, directly or through its agent, has executed a written loan and security agreement with the borrower. The corporate or its agent ensures compliance with the agreements.
(f) *Investment companies*. A corporate credit union may invest in an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a), provided that the prospectus of the company restricts the investment portfolio to investments and investment transactions that are permissible for that corporate credit union.
(g) *Forward settlement of transactions later than regular way*. A corporate credit union may enter into an agreement to purchase or sell an instrument, with settlement later than regular way, provided that:
(1) Delivery and acceptance are mandatory;

(2) The transaction is clearly disclosed in the appropriate risk reporting required under § 704.8(b);
(3) If the corporate credit union is the purchaser, it has adequate cash flow projections evidencing its ability to purchase the instrument;
(4) If the corporate credit union is the seller, it owns the instrument on the trade date; and
(5) The transaction is settled on a cash basis at the settlement date.

(h) ***Prohibitions***. A corporate credit union is prohibited from:
(1) Purchasing or selling derivatives, except for embedded options not required under GAAP to be accounted for separately from the host contract or forward sales commitments on loans to be purchased by the corporate credit union;
(2) Engaging in trading securities unless accounted for on a trade date basis;
(3) Engaging in adjusted trading or short sales; and
(4) Purchasing mortgage servicing rights, small business related securities, residual interests in collateralized mortgage obligations, residual interests in real estate mortgage investment conduits, or residual interests in asset-backed securities; and
(5) Purchasing stripped mortgage backed securities (SMBS), or securities that represent interests in SMBS, except as described in subparagraphs (i) and (iii) below.
(i) A corporate credit union may invest in exchangeable collateralized mortgage obligations (exchangeable CMOs) representing beneficial ownership interests in one or more interest-only classes of a CMO (IO CMOs) or principal only classes of a CMO (PO CMOs), but only if:
(A) At the time of purchase, the ratio of the market price to the remaining principal balance is between .8 and 1.2, meaning that the discount or premium of the market price to par must be less than 20 points;
(B) The offering circular or other official information available at the time of purchase indicates that the notional principal on each underlying IO CMO should decline at the same rate as the principal on one or more of the underlying non-IO CMOs, and that the principal on each underlying PO CMO should decline at the same rate as the principal, or notional principal, on one or more of the underlying non-PO CMOs; and
(C) The credit union investment staff has the expertise dealing with exchangeable CMOs to apply the conditions in paragraphs (h)(5)(i)(A) and (B) of this section.
(ii) A corporate credit union that invests in an exchangeable CMO may exercise the exchange option only if all of the underlying CMOs are permissible investments for that credit union.
(iii) A corporate credit union may accept an exchangeable CMO representing beneficial ownership interests in one or more IO CMOs or PO CMOs as an asset associated with an investment repurchase transaction or as collateral in a securities lending transaction. When the exchangeable CMO is associated with one of these two transactions, it need not conform to the conditions in paragraphs (h)(5)(i) (A) or (B) of this section.
(i) *Conflicts of interest*. A corporate credit union's officials, employees, and immediate family members of such individuals, may not receive pecuniary consideration in connection with the making of an investment or deposit by the corporate credit union. Employee compensation is exempt from this prohibition. All transactions not specifically prohibited by this paragraph must be conducted at arm's length and in the interest of the corporate credit union.
(j) *Grandfathering*. A corporate credit union's authority to hold an investment is governed by the regulation in effect at the time of purchase. However, all grandfathered investments are subject to the requirements of §§ 704.8 and 704.9.

Appendix III: Current Regulation Surrounding Credit Risk Management for Corporates

§ 704.6 Credit risk management.
(a) *Policies*. A corporate credit union must operate according to a credit risk management policy that is commensurate with the investment risks and activities it undertakes. The policy must address at a minimum:
(1) The approval process associated with credit limits;
(2) Due diligence analysis requirements;
(3) Maximum credit limits with each obligor and transaction counterparty, set as a percentage of capital. In addition to addressing deposits and securities, limits with transaction counterparties must address aggregate exposures of all transactions including, but not limited to, repurchase agreements, securities lending, and forward settlement of purchases or sales of investments; and
(4) Concentrations of credit risk (*e.g.*, originator of receivables, insurer, industry type, sector type, and geographic).
(b) *Exemption*. The requirements of this section do not apply to investments that are issued or fully guaranteed as to principal and interest by the U.S. government or its agencies or enterprises (excluding subordinated debt) or are fully insured (including accumulated interest) by the NCUSIF or Federal Deposit Insurance Corporation.
(c) *Concentration limits*—(1) *General rule*. The aggregate of all investments in any single obligor is limited to 50 percent of capital or $5 million, whichever is greater.
(2) *Exceptions*. Exceptions to the general rule are:
(i) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 200 percent of capital; (ii) Investments in corporate CUSOs are subject to the limitations of § 704.11; and
(iii) Aggregate investments in corporate credit unions are not subject to the limitations of paragraph (c)(1) of this section.
(3) For purposes of measurement, each new credit transaction must be evaluated in terms of the corporate credit union's capital at the time of the transaction. An investment that fails a requirement of this section because of a subsequent reduction in capital will be deemed non-conforming. A corporate credit union is required to exercise reasonable efforts to bring nonconforming investments into conformity within 90 calendar days. Investments that remain nonconforming for 90 calendar days will be deemed to fail a requirement of this section and the corporate credit union will have to comply with § 704.10.
(d) *Credit ratings*.—(1) All investments, other than in a corporate credit union or CUSO, must have an applicable credit rating from at least one nationally recognized statistical rating organization (NRSRO).
(2) At the time of purchase, investments with long-term ratings must be rated no lower than AA– (or equivalent) and investments with short-term ratings must be rated no lower than A–1 (or equivalent).
(3) Any rating(s) relied upon to meet the requirements of this part must be identified at the time of purchase and must be monitored for as long as the corporate owns the investment.
(4) When two or more ratings are relied upon to meet the requirements of this part at the time of purchase, the board or an appropriate committee must place on the § 704.6(e)
(1) Investment watch list any investment for which a rating is downgraded below the minimum rating requirements of this part.
(5) Investments are subject to the requirements of §
704.10 if:
(i) One rating was relied upon to meet the requirements of this part and that rating is downgraded below the minimum rating requirements of this part; or

(ii) Two or more ratings were relied upon to meet the requirements of this part and at least two of those ratings are downgraded below the minimum rating requirements of this part.
(e) *Reporting and documentation*. (1) At least annually, a written evaluation of each credit limit with each obligor or transaction counterparty must be prepared and formally approved by the board or an appropriate committee. At least monthly, the board or an appropriate committee must receive an investment watch list of existing and/or potential credit problems and summary credit exposure reports, which demonstrate compliance with the corporate credit union's risk management policies.
(2) At a minimum, the corporate credit union must maintain:
(i) A justification for each approved credit limit;
(ii) Disclosure documents, if any, for all instruments held in portfolio. Documents for an instrument that has been sold must be retained until completion of the next
NCUA examination; and
(iii) The latest available financial reports, industry analyses, internal and external analyst evaluations, and rating agency information sufficient to support each approved credit limit.

Appendix IV: Current Regulation Surrounding Corporate Asset Liability Management

Regulation 704.8, Asset and Liability management.

(d) *Interest rate sensitivity analysis*.

(1) A corporate credit union must:

(i) Evaluate the risk in its balance sheet by measuring, at least quarterly, the impact of an instantaneous, permanent, and parallel shock in the yield curve of plus and minus 100, 200, and 300 basis points on its NEV and NEV ratio. If the base case NEV ratio falls below 3 percent at the last testing date, these tests must be calculated at least monthly until the base case NEV ratio again exceeds 3 percent;

(ii) Limit its risk exposure to levels that do not result in a base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section below
2 percent; and

(iii) Limit its risk exposures to levels that do not result in a decline in NEV of more than 15 percent.

(2) A corporate credit union must assess annually if it should conduct periodic additional tests to address market factors that may materially impact that corporate credit union's NEV. These factors should include, but are not limited to, the following:

(i) Changes in the shape of the Treasury yield curve;

(ii) Adjustments to prepayment projections used for amortizing securities to consider the impact of significantly faster/slower prepayment speeds;

(iii) Adjustments to the market spread assumptions for non Treasury instruments to consider the impact of widening spreads; and

(iv) Adjustments to volatility assumptions to consider the impact that changing volatilities have on embedded option values.